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California Takes Fiscal-Stress Test

New Taxes, Cuts in Services among Plans Considered To Avoid Big Budget Deficit

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By Jim Carlton

SACRAMENTO, Calif. -- California's ballooning budget deficit will test Gov. Arnold Schwarzenegger as he balances raising taxes and cutting services.

Mr. Schwarzenegger last week said he would declare a fiscal emergency in the state, which faces a projected \$14.5 billion gap over two years, convening legislators next month to consider cuts to an array of services. Many state officials say the projected budgetary gap is so vast that new taxes may be required to balance the budget. That is likely to set off a new round of partisan wrangling, and test Mr. Schwarzenegger's mettle. Many legislators in the Republican minority say they won't sign off on any taxes; many Democrats say there may be no other choice.

"For us, I'm very clear: Taxes are not an option," says Michael Villines, the Assembly Republican leader.

California's projected budget shortfall during the next two years is precipitated in part by the subprime-mortgage collapse, which is also wreaking havoc in other states as borrowers default or curb their spending to cope with higher rates on adjustable-rate loans. Florida faces an additional \$1 billion budgetary shortfall in 2008 after addressing a \$1.1 billion deficit this year. Arizona estimates at least an \$800 million deficit in the current fiscal year. In all, 15 states face either deficits or lower-than-expected revenues stemming in part from the subprime crisis, according to the National Association of State Budget Officers.

No governor faces a more formidable challenge than Mr. Schwarzenegger, who rode into office in 2003 after his Democratic predecessor became ensnared in a California budget crisis. As recently as June, California had a \$4.1 billion reserve set aside for emergencies, thanks to several years of a booming housing market and sharp increases in personal income tied to a strong stock market.

At the same time, California housing sales have cooled as rates on adjustable mortgages have climbed. California tops the country in foreclosure filings, with Central Valley and Southern California cities among the hardest hit. State officials say a spending pullback by cash-strapped borrowers has resulted in a sharp slowdown in the revenues the state gets on taxable sales, which account for nearly one-third of California's approximate \$100 billion general fund.

With taxable sales growth slowing to 1.3% in the second quarter from as high as 7.4% in 2005, those revenues for the current fiscal year are now projected to be as much as \$624 million lower than expected, according to estimates by California Legislative analyst Elizabeth Hill. California is more reliant on sales and income taxes than other states, in part because of property-tax limits voters imposed under Proposition 13 in 1978.

As a result, Gov. Schwarzenegger on Friday projected that California faced a budget deficit during the next two years of \$10 billion to \$14 billion; people familiar with the situation say the shortfall is expected to be \$14.5 billion. State agencies have been notified to prepare for cuts that could total as much as 10% each. The governor's budget advisers note the state's general economic condition remains healthy, with job growth continuing despite the housing problems.

Mr. Schwarzenegger faces a tough road in resolving the shortfall. California is one of only a few states where two-thirds of legislators, rather than a simple majority, have to sign off on any tax increase.

With Republicans in the statehouse effectively blocking most new taxes, lawmakers in recent years have relied on ballot measures to get more money. Indeed, after ousting Gov. Gray Davis in a recall election four years ago, Mr. Schwarzenegger resolved the last budget crisis by getting California voters in 2004 to pass \$15 billion in bonds.

Mr. Schwarzenegger faces other challenges, too. Some of the governor's fellow Republicans are chafing over his support for a state Assembly bill passed Monday that would create the nation's largest universal health-care plan. Since Assembly Republicans have indicated they wouldn't approve any additional taxes to fund the plan, the bill was written so it would have to go before voters next year to approve the \$14.4 billion in financing with new levies on tobacco products, hospitals and employers.

Even some Democrats are leery of the health bill. Don Perata, a Democrat and president of the state Senate, which also has to sign off on the bill, says he wouldn't call for a vote by his members until after the fiscal impact of the health plan can be better assessed.

Meanwhile, powerful interest groups are poised to defend big recipients of state funding, such as education. Fully 40% of the state's approximate \$100 billion-a-year general-fund budget goes to schools from kindergarten through community college. "Nobody wants to start there," says Craig Cornett, budget director for Assembly Speaker Fabian Núñez.

Other options include more borrowing, but that is limited because the state floated \$11.3 billion in bonds to get out of its last fiscal crisis two years ago. "I think it's going to be incredibly difficult to resolve this budget problem," said Ms. Hill.

Mr. Schwarzenegger and his advisers say the real problem is that the way the state's budget is devised needs to be changed. One suggestion: more public-private partnerships for infrastructure projects to lessen the state's financial load.

"What we have to do is fix the budget system," Mr. Schwarzenegger said in a speech Friday in Long Beach. "The system itself needs to be fixed, and I think this is a good year, this coming year, to fix it."